Panayotis Thomopoulos: Great expectations for 2004 - a year of optimism?

Speech by Mr Panayotis Thomopoulos, Deputy Governor of the Bank of Greece, at the Economist Conference, Athens, 7 May 2004.

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I am glad that I can answer the question posed for this session in the affirmative. Yes, 2004 is a year of optimism, and, provided that appropriate policies are introduced, optimism should continue in 2005 as well. However, since we are living in a rapidly changing world, single global periodic shocks of various origins are, unfortunately, becoming a routine and since macroeconomic equilibria and "harmonious" growth are mirages, the answer cannot be a simple Yes. It is more propitious to say yes, but. Ôhe but refers to two factors. First, there are growing divergences in economic performance across the globe, with the result that the dividends of the recovery are not being evenly spread among the major regions of the world. Although the differences in economic performance can be attributed mainly to domestic factors, the policies of certain economic powers are also contributing to the sub-optimal performance of other regions. Second, looking further ahead, it is appropriate to sound a warning that in an uncertain international environment governments, central banks and financial supervisors as well as the private sector should not take for granted the recent good performance. Rather they should take decisive action to prolong this recovery and avoid the realization of downside risks.

After three miserable years of below par growth, it is now clear that the world economy has entered a period of improving economic performance. World output is expected to increase by 4.6 percent this year, 50% faster than in the previous two years, while world trade, which practically stagnated in 2001 and 2002, will increase by nearly 8 percent this year. Although this performance falls short of the heady days of the late 1990s, it is a significant improvement over the recent past.

This rebound now covers practically the whole world, albeit to varying degrees, with most major countries benefiting from accelerating growth. However again the rate of growth in certain regions will continue to be considerably below their potential rate. Even Japan is now looking forward to a durable recovery in part as a result of the decrease in banks' contingent liabilities and of strong export demand, especially from China. Many Latin American countries have turned the page of distress and have been recording fast, though still fragile, growth. Argentina's growth is impressive, some 10%, but unless it clears its foreign debt hurdle there is no guarantee that the recent performance will continue over the medium term. Russia and a few transition economies also show strong growth, although, as in the case of many Latin America countries, the boom in raw materials and energy prices has significantly contributed to this outcome. To a large extent, this world recovery is due to the strength of the Asian economies, which have overcome the trauma of the crisis in 1997-98 and are now growing again at rates around 6-7 percent. It is not only the Asian dragons and China (the latter leading with a rate of growth of slightly above 10% annually), but particular mention should also go to India, which is now reaping the benefits of the liberalization it introduced after the mid-1990s and is now growing at 7%, a rate more than double its customary 3 percent. It should be recalled that the US is also growing rapidly and its import demand has continued to be a source of growth for the world economy. Whereas some 10 years ago the E.U. was the main beneficiary of dynamic US demand, nowadays the center of gravity has moved to the Pacific rim. This is reflected in a rate of growth of world trade in the Pacific rim estimated at about 11% on average in 2003/2004, which is more than three times the corresponding rate of growth of the overseas trade of the EU. In 2003 more than one quarter of the increase in world trade was due to China, whose international trade grew at almost 40% last year. The east Asian tigers (Korea, Taiwan, Thailand, Malaysia) have been dwarfed by a Colossus which, however, has the vitality of a tiger. In order to better gauge the growing role of China in the world economy, assuming that its high growth rate continues, we can calculate that the annual increment of its GDP in the years to come is as if a country of almost the size of Spain (the 9th biggest market economy worldwide) was being integrated into the world economy every year.

Accelerating growth is taking place in a non-inflationary climate, with price increases remaining at or below 2 percent in the developed world and in many emerging economies. We can now take comfort that we have, at least temporarily, tamed the beast of inflation that bedeviled our economies in the

1970s and 1980s, while the fears of deflationary pressures that were widespread last summer have certainly not materialized. These improvements are partly due to improved macroeconomic policies, but they also reflect fundamental changes as a result of new technologies, as well as a more competitive and pro-business climate all over the world. The rapidly growing share of world exports originating from the low labor cost countries (China, India and others) is also exerting a downward pressure on prices globally. The much-maligned dotcom bubble did reflect an improvement in technological possibilities, which we are now observing as increasing productivity in many countries. It is not for nothing that much of the global investment revival now comes from the technology sector.

Within this overall booming environment, it is slightly distressing that the core economies of the eurozone remain the laggards. Although all European economies have now emerged from recession, the three main economies, Germany, France and Italy, will see very modest growth of less than 1 ½ percent in total this year. Certainly, this slow growth cannot be blamed on macroeconomic factors, which remain conducive to growth. The external environment is improving fast, monetary policy, as conducted by the ECB, remains supportive of growth, and fiscal policy, as reflected in an overall fiscal deficit in the eurozone of close to 3 percent, is expansionary. Even the euro's appreciation has been halted and wage growth remains moderate at 2¾% annually. While it is easy to eliminate macroeconomic policy as the cause of slow growth in the eurozone, it is much more difficult to pinpoint the culprits of this sluggish recovery.

Maybe there is no single cause, and the situation differs from country to country. Some eurozone members, like Italy, have difficulty adapting to a situation where the nominal exchange rate is appreciating and the country faces growing competition from low-cost producers in many of its traditional industrial sectors (textiles, shoe making, garments etc.). Prior to Eurozone membership, many, especially in the business sector, had taken it for granted that the exchange rate only depreciates. In other countries, the uncertainties induced by the stubbornly high unemployment rate and the slow progress in structural changes are depressing economic sentiment and are holding back consumption and investment, despite the marked improvements in corporate profitability across sectors in 2003 & 2004. I do not think that the Eurozone is facing the fundamental problems that Japan faced over the last ten years. It is more the confluence of many factors that exert a negative influence on our economies. Pessimism is one of them and has permeated many economic circles and is in itself a worrying phenomenon. This is reflected in the fact that the recent recovery, instead of being compared to stronger previous cyclical recoveries, is compared to the worst phases of the cycle - the declining output towards the end of 2002 and the first half of 2003. In the same vein, a very low potential rate of growth of barely above 2% per year for the Euroarea is considered by many as a normal benchmark against which outcomes are measured. Therefore, a 0,5% shortfall, i.e. a rate of growth in the Euroarea of about 1.5% as is projected for 2004, is implicitly considered broadly satisfactory, despite the fact that there is still a negative output gap. Given the interaction between actual GDP growth and potential growth, a sharper rebound of the Euroarea, as was the case in cyclical upturns in the past, would by itself have raised the rate of growth of potential GDP. Indeed, if assisted by bold structural reforms the rate of growth of potential in the Euroarea could be raised to over 2.5%, the same rate as in the 1980s and a rate more normal for mature economies. The potential rate of growth of the US has averaged just over 3% over the last twenty five years. If too much pessimism regarding the potential rate of growth dampens actual growth and, therefore, may to some extent be self-fulfilling, equally dangerous is over-optimism, or better (to use the famous words) irrational exuberance, that is quickly disproven. What is needed is a sober assessment of the situation and the introduction urgently of appropriate structural reforms, so that not only macro - but also micro - economic policies are geared to supporting a stronger non-inflationary growth than today.

Though the cause of to-day's ills in the Euroarea are essentially of domestic origin, I hinted earlier that exchange rate policies followed by certain heavy weights in international trade have resulted in a real effective appreciation of the euro more than is warranted and, moreover, it seems that from a dynamic point of view the appreciation is much greater than the published figures show, which are necessarily based on past data. As a result, whereas the Euroarea, one of the richest regions of the globe should have had a sizeable current account surplus so as to fulfill its natural world role as a sizeable capital exporter (a surplus would also be expected because of its weak cyclical phase), the current account surplus of the Euroarea has averaged only $17 billion annually since 2000, compared to $26 billion for China and $ 80 billion for the dragons, whose per capita income is still relatively low. Of course, if Euroarea growth was faster, this aspect would not be so important since more market determined exchange rates in these countries would probably only add not more than one quarter of a percentage point to Euroarea growth. However, with average growth in the Euroarea of less than 0.7% in 2002/2003, even a small stimulus matters.

In this context I would like to say something about the Greek economy itself. Unlike our partners in the EU, we are now enjoying strong growth that will stay close to 4 percent this year as in the last five years. Admittedly, the stimulus from the forthcoming Olympic Games and the inflow of EU structural funds has contributed to the good economic performance; but I think it is true to say that endogenous factors have been significantly more important. Public expenditure on the Olympic Games, amounting to just over 1% of GDP in the last few years, has also had the negative effect of raising the fiscal deficit to about its upper limit of 3%, set by the European Treaty, and has also intensified inflationary expectations. As a result external competitiveness will again probably be eroded somewhat in 2004, in turn restraining GDP growth. As for financial support from the E.U., it is worth mentioning that net inflows from the E.U. have fallen from over 5% of GDP at the end of 1990s to 2.8% in 2003. The Greek economy has succeeded in absorbing this negative shock without strains and the probable further decline in net E.U. funds, after 2007, which is related to E.U. enlargement, does not pose a serious threat to growth. Against these negative influences there is an array of positive factors, starting from the fundamental changes in the economy that have occurred in the last fifteen years and are easily visible to the naked eye. Not only is the economy functioning more efficiently, and reflecting a high investment-to-GDP ratio of 26%, the capital base both in the private and public sector has broadened and deepened, but also business initiative is on the rise, and the factors in combination with the removal of exchange rate risk and low interest rates creates a more stable environment and helps promote both consumption and private investment. Greece, being close to the fast-growing economies of Eastern Europe and the Balkan area, benefits from its ever-improving economic links with them and is becoming a hub for many of them. We are also seeing the first fruits of the heavy infrastructure investment and structural reforms we undertook in recent years, which underpin a relatively fast rate of underlying productivity growth, at almost 3%, or nearly three times that of the Euroarea. While some deceleration of growth immediately and for a short period after the Olympics may occur, I remain confident that Greece will stay on a dynamic growth path for years to come provided that fiscal consolidation accelerates and bureaucratic blockages are eliminated.

While one can be fairly confident about the world economy's prospects for 2004, I have already hinted that challenges may emerge in 2005 and beyond. Real GDP growth is not expected to accelerate in 2005, while the downside risks loom larger. These challenges are a bit further down the road, but in a fast-moving world prevarication is not a good strategy and I shall mention the most important:

Certainly, the largest threat looming over the world economy in the medium-to-longer term is the "twin deficits" in the US. The fiscal deficit is the most worrying and despite plans for a drastic cut over the next few years, it may be difficult to achieve it in the light of the U.S. involvements worldwide, the likely increase in the interest rate on Treasury Bills, and a projected slowdown of economic growth from the high rate of 4.7% estimated for 2004. Only ambitious measures could make a significant dent in the fiscal deficit and this is needed both for the US and for the stability of the world economy.

A decline of the fiscal deficit will by itself reduce somewhat the current account deficit. But, given the asymmetry between the high income elasticity of demand for imports in the US of over 2 and the low foreign income elasticity for US exports only of 1, only a partial correction is possible. Elimination of the current account deficit cannot, therefore, be envisaged under present conditions and, moreover, it is not needed. Given the safe heaven status and high profitability in the US, financing the balance of payments deficit is less of a problem. Indeed the fears that the deficit would trigger further rapid depreciation of the US dollar, equal to that seen in the last two years, have not materialized and most likely will not materialize. The world is finally getting accustomed to the idea that a structural deficit of around 3% of GDP over the medium term can be sustained, and this should be the goal.

The rise in the price of oil close to $40 per barrel is a serious threat to the world economic recovery and needs to be urgently addressed. If maintained, such a high price could impact negatively to the tune of 0.5% of GDP over the next eighteen months and will exacerbate inflationary pressures. Fast rising world demand, especially in China with its low energy and raw-material efficiency (as in the case for energy in the US), is an important factor behind the steep rise of oil and particularly of raw and intermediate material prices. On the supply side, the policy of some big oil producing countries, which have subordinated the goal of a stable international environment conducive to sustainable growth world-wide to their short-run need for revenues to cover fiscal deficits, is also contributing to the maintenance of high oil prices. Political factors may have also played role in the changing attitude of some producers. The rise in oil and raw material prices is accentuating inflationary pressures and may lead to a premature monetary policy tightening in many countries, especially if these pressures are allowed to spill over to wages. Such a move would definitely lead to even slower growth than the mechanical impact of the rise in the oil price would suggest. Especially in the US, which has followed an expansionary monetary policy in the last few years, a rise in interest rates may have a strong cumulative impact on growth. Though such a development would help reduce the current account deficit it will certainly make fiscal consolidation in the US even more difficult.

Last, but not least, Chinese growth may slow, but this is a welcome development since recent very strong growth was exacerbating disequilibria in China and world-wide. The authorities seem to have realized that growth close to 10-12%, as recorded in the last few quarters, intensifies inflationary pressures and encourages investments in uneconomical projects, which have no chance to service their debt. The official inflation rate of 3% is being questioned in financial circles, which estimate that actual inflation is closer to 6% and if we include real estate and asset prices, inflation probably is even higher. Recently, the central bank tightened monetary conditions and introduced credit restrictions and the authorities ordered the postponement and even cancellation of many projects not only in order to prevent overheating but also in order to encourage banks to clear their non-performing portfolio and increase their capital base. The authorities seem also to be considering an appreciation of the renminbi, though not immediately, which would ease inflation and contribute to a better management of their financial resources. We have to see whether these measures will contribute to a soft-landing, thus allowing China to avoid the bitter experience of some of its neighbors in 1997-1998, when their credit and asset inflation bubble burst. The rate of growth of potential output in China is estimated at around 7% per annum, which is still high, and thus China will continue to be a dynamic player in the world economy, while at the same time help to stem the rising disequilibria world wide.